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IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

No. 617

L & M REALTY CORPORATION,
A Virginia Corporation, Alleged Bankrupt,
Petitioner

v.

RENA C. LEO, Executrix of the Estate
of Dr. Louis S. Leo, Deceased,
Petitioning Creditor,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

NORRIS E. HALPERN,
508 National Bank of Commerce Bldg.
Norfolk, Virginia
Counsel for Petitioner

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Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

L & M Realty Corporation, a Virginia Corporation, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit, entered in the above-entitled case on December 6, 1955.

CITATIONS TO OPINIONS BELOW

The memorandum opinion of the Referee In Bankruptcy is unreported and is printed in Appendix B hereto, infra page 8. The opinion of the District Court printed in Appendix B hereto, infra page 1 is reported in 131 Fed. Supp. 57. The opinion of the Circuit Court of Appeals, printed in Appendix A hereto, infra page 1 has not yet been reported.

JURISDICTION

The judgment or decree of the Circuit Court of Appeals was entered on December 6, 1955. (Appendix A, page 1.)

The jurisdiction of this Court is invoked under 28 U. S. Code, Section 1254(1).

QUESTION PRESENTED FOR REVIEW

Do payments by a close corporation, composed of only two stockholders, to two banks, who are the only creditors of the corporation (except for advances to the corporation made by those same two stockholders) of notes made by said Corporation payable to said banks, bearing the endorsements of both stockholders, constitute a preference under 11 USC 96 (a) (1) justifying the maintenance of a petition in involuntary bankruptcy by one of said stockholders, where such payments to the banks leave the Corporation without funds sufficient to pay the endorsing stockholders the amount of their advances?

STATUTE INVOLVED

The statutory provision involved in this case appears in 11 USC 96 (a) (1) and is as follows:

"(a) (1) A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor, for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class."

STATEMENT OF THE CASE

L & M Realty Corporation is a Virginia Corporation, composed of only two stockholders, Dr. Louis S. Leo, who died on March 17, 1954, and Dr. Edward Myers. On or about August 12, 1954, the Corporation paid the National Bank of Commerce of Norfolk, at Norfolk, Virginia, the sum of $9,000.00 and interest, due by it to said bank on a note endorsed by both stockholders, and also paid the Seaboard Citizens National Bank of Norfolk, Virginia, the sum of $5,000.00 plus interest due by it to said bank on a note likewise endorsed by both stockholders. These two banks were the only creditors of the corporation, except for the fact that Dr. Leo and Dr. Myers had each advanced the corporation approximately $17,000.00, which advances had not been repaid as of August 12, 1954. The payments to the banks admittedly left the corporation without funds to repay the stockholders for their advances.

On August 16, 1954, Dr. Leo's personal representative filed a petition in involuntary bankruptcy claiming that the payments to the banks created a preference, enabling the banks to obtain a greater per-

centage of the respective debts due them than other creditors of the same class.

The corporation thereupon filed its answer setting up ten defenses to the petition, only one of which was considered by the Referee to whom the cause was referred, namely the Fourth Defense which denied that the payments constituted a preference whereby said banks obtained a greater percentage of the debts due them than other creditors of the same class.

On November 4, 1954, the Referee sustained the Fourth Defense and dismissed the petition.

On November 24, 1954, a petition for review was filed in the United States District Court for the Eastern District of Virginia.

On May 5, 1955, the Honorable Walter Hoffman, Judge of said latter Court, handed down an opinion affirming the judgment of the Referee and dismissing the petition in involuntary bankruptcy on the ground that the payments to the two banks did not create a preference as to the two stockholders.

The case was appealed to the United States Court of Appeals for the Fourth Circuit, at Richmond, Virginia.

On December 6, 1955, said Circuit Court of Appeals in a split decision reversed the lower court and held that the payments to the banks constituted a preference as to the two remaining stockholders, the Honorable Judge Soper dissenting.

The basis for Federal jurisdiction in the court of first instance was the Bankruptcy Act.

REASONS FOR ALLOWING THE WRIT

1. The decision of the Fourth Circuit in the instant case is in direct conflict with the decision of the Seventh Circuit in the case entitled Doyle v. Milwaukee National Bank of Wisconsin, In re Harpke et al., 116 Fed. 295. In that case a bank held two notes of the same maker, one being secured by an endorser. The endorser paid the note on which he was liable with money supplied by the maker. Within four months thereafter the maker was adjudged a bankrupt and in fact was insolvent when the first note was paid. In this case it was held that such payment was not a preference which the bank must surrender as a condition precedent to the proving of the second note against the bankrupt's estate, since the effect of its enforcement would not be to enable the bank to obtain a greater percentage of its debt than other creditors of the same class.

Since the Harpke case, Swartz v. Fourth National Bank, 117 Fed. 1 (8th Circuit) and Livingstone v. Heineman, 120 Fed. 786 (6th Circuit) were decided. These two circuits refused to follow the Harpke case, supra, and repudiated the doctrine there enunciated.

2. The Fourth Circuit in the case at bar, in apparently following the decision of Swartz v. Fourth National Bank, supra, refused to follow the principles laid down in that case, which are pertinent to the case at bar.

In the Swartz case, at page 12, appears the following statement of law applicable to the instant case:

> "The contract of Siegel and Bro. (the endorsers) shows that they would pay these notes if the bankrupt did not. By that contract they were estopped from collecting or receiving anything

upon or account of them from the bankrupt estate, which still owes the full amount of them, until the bank has received the $14,600.00 still due it on the notes."

This statement of law applied to the case at bar. Yet the Fourth Circuit in this case refused to follow the doctrine of estoppel laid down in the Swartz case.

In the case at bar, Dr. Leo and Dr. Myers were endorsers on the notes due to and paid to the banks. By their contract of endorsement they in effect stated to the banks that they would pay the notes if the corporation could or did not do so. The banks were not looking alone to the corporation for they obviously would not have made the loans to the corporation without the added security of the endorsements. Under these facts, are not the endorsers estopped to assert that they are entitled to share equally with the banks, on a debt which they agreed to pay if the corporation did not pay? By failing to follow the Swartz case in this particular, a conflict between Circuit Courts has been created and should be resolved by this Honorable Court.

3. Clearly the question presented by this case is, while novel among reported cases, of importance to the administration of the Federal Bankruptcy laws. The Supreme Court of the United States has not to date handed down a single decision which we could find defining a "creditor of the same class" as set out in 11 USC 96 (a) (1), or what constitutes a payment enabling a creditor to obtain a greater percentage of the debt due him than other creditors of the same class.

Most corporations in existence today are close corporations. They are formed daily by the hundreds. In practically every instance, the stockholders invest

small amounts in capital and treat the rest of their investment as loans to the corporation, in order to obtain a tax advantage through the siphoning off of profits as interest on loans, and in order to share with other creditors in the event of bankruptcy or insolvency. Recognizing this, the Federal Government passed a law dealing with thinly capitalized corporations, and this Honorable Court laid down certain equitable principles hereinafter referred to, subordinating the claims of stockholders in close corporations to those of other creditors. The practice none the less persists, and in all such close corporations loans are obtained from banks, and invariably the banks require the stockholders and officers to endorse the notes of the corporation involved. Therefore, settlement of the question presented by this petition is obviously in the public interest, since it is likely to be presented in almost every bankruptcy proceeding affecting closely held corporations.

4. The decision of the Court below is believed to be erroneous and conflicts with the salutary principles of law, laid down by this Honorable Court in the case of Pepper v. Litton, 308 U. S. 295; 60 S. Ct. 238, 84 L. Ed. 281. At page 304, this Honorable Court had this to say:

> "Consequently this Court has held that for many purposes 'Courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity.' Local Loan Co. v. Hunt, 292 U. S. 234, 240. . . .
>
> "The bankruptcy courts have exercised these equitable powers in passing on a wide range of problems arising out of the administration of bankrupt estates. They have been invoked to the end that fraud will not prevail, that substance will not

give way to form, that technical considerations will not prevent substantial justice from being done. By reason of the express provisions of Section 2, these equitable powers are to be exercised on the allowance of claims, a conclusion which is fortified by Section 57(k). For certainly, if as provided in the latter section, a claim which has been allowed, may be later rejected in whole or in part, according to the equities of the case, *disallowance or subordination in light of equitable consideration may originally be made* (Italics supplied).

"That equitable power also exists in passing on claims presented by an officer, director or stockholder in the bankruptcy proceedings of his corporation. The mere fact that an officer, director or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it 'pari passu' treatment with the claims of other creditors."

5. The majority decision of the court below conflicts with the equitable principles laid down by this Honorable Court in the following cases:

American Surety Co. v. Electric Co.	296 US 133
American Surety Co. v. Sampsell	327 US 269
Jenkins v. National Surety Co.	277 US 258

That equitable principle is that a surety has no right to share in a bankrupt's estate on equal terms with a creditor whom the surety has undertaken to secure.

The majority opinion in the case at bar overlooks completely the equitable principles referred to and adopt "a lien" theory repugnant to the equitable principles which of necessity apply to all bankruptcy proceedings. The majority of the court ruled that the

endorsers had no lien or priority upon the assets of the bankrupt by virtue of their endorsement, and therefore they stand in the same class as the banks. However, this Honorable Court has held that principles of equity apply to bankruptcy proceedings. Applying equitable principles to the case at bar, we must conclude that it is grossly inequitable to permit the endorsers on notes due the banks to share pro-rata with the banks, and leave the banks the task of proceeding against the individual estates of the endorsers. If both individual estates were insolvent and heavily indebted on preferred and secured claims, then it is obvious that the banks would be left unpaid despite the precautions they took to protect their claims by insisting upon personal endorsements at the time the loans were made.

The majority opinion seeks to protect creditors of a stockholder. The sole purpose of 11 USC 96 (a) was to prevent a creditor in these proceedings from obtaining a greater percentage of his debt than some other creditor in the same proceeding who is in the same class. It was not designed to protect individual creditors of a creditor in a bankruptcy proceeding.

As Judge Soper eloquently stated in his dissenting opinion set out in the appendix of this petition:

> "It is conceded in the opposing argument that if Leo's estate were solvent, the payments to the banks would not have prejudiced the other two creditors because each of them would have been relieved of his obligation as endorser. This is true, but it is also conclusive of the whole controversy. It is manifest that Leo, insolvent, had no greater claim against the corporation than Leo, solvent, would have had. Undoubtedly the effect of the payments to the banks was to deprive Leo's creditors of a share of the assets of the bankrupt corporation,

but Leo's creditors had no greater right to object than Leo himself. The argument confuses the creditors of Leo with the creditors of the bankrupt corporation. The section of the bankruptcy act which defines the preferential transfer of the property of an insolvent is designed to protect *his* creditors; but is not concerned with the creditors of his creditors."

CONCLUSION

For the foregoing reasons this petition for a writ of certiorari should be granted.

Respectfully submitted,

NORRIS E. HALPERN,

Counsel for Petitioner

NORRIS E. HALPERN
Counsel for Petitioner
303 National Bank of Commerce Building
Norfolk 10, Virginia

I, Samuel Goldblatt, of Counsel for Respondent, do hereby acknowledge that a copy of the foregoing petition for a writ of certiorari was duly served upon me by delivery of the same to me by Counsel for Petitioner this 6th day of January, 1956.

SAMUEL GOLDBLATT

of Counsel for Respondent

UNITED STATES COURT OF APPEALS

FOR THE FOURTH CIRCUIT

No. 7070

RENA C. LEO, Executrix of the Estate of Dr. Louis S. Leo, Deceased, petitioning creditor,
Appellant

v.

L & M REALTY CORPORATION, a Virginia corporation, Alleged Bankrupt,
Appellee

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA, AT NORFOLK.

(Argued Oct. 20, 1955—Decided Dec. 6, 1955)

Before PARKER, Chief Judge and SOPER and DOBIE, Circuit Judges.

Paul M. Lipkin (Goldblatt & Lipkin on brief) for Appelant, and Morris E. Halpern for Appellee.

PARKER, Chief Judge:

This is an appeal from an order dismissing a petition of the Executrix of Dr. Louis S. Leo asking that the L & M Realty Corporation be adjudged an involuntary bankrupt because of alleged preferential payments made to two banks while the corporation was insolvent.

All of the stock of the corporation was owned by Dr. Leo and a Dr. Myers. The corporation was indebted to Leo in the sum of $17,501.85 and to Myers in approximately the same amount. It owed no other debts except $14,000 to two banks, evidenced by notes indorsed by both Leo and Myers. After the death of Leo, while the corporation was insolvent and within four months of the filing of the petition in bankruptcy, Myers caused it to pay to the banks the full amount of the notes which he and Leo had indorsed and this exhausted the corporation's assets, leaving nothing to be paid upon the indebtedness due to him and to Leo. The trial judge stated in his opinion that the estate of Leo was insolvent, although it is said here that there was nothing to support this finding except a statement in open court by counsel for the estate.

There can be no question but that the indebtedness due the bank, being unsecured and not being entitled to any priority of payment over other creditors, was in the same class as the indebtedness due to Myers and Leo even though the note evidencing the indebtedness had been indorsed. *Swartz v. Fourth National Bank,* 8 Cir. 117 F. 1; *Livingstone v. Heineman,* 6 Cir. 120 F. 786. This being true, the payment to the bank constituted a preferential payment to a creditor which was an act of bankruptcy. It resulted in the payment in full of one of the creditors of the insolvent corporation to the exclusion of other creditors of the same class. The bankruptcy Act as amended, 11 USC 96(a) provides:

> "(a) (1) A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the

filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor a greater percentage of his debt than some other creditor of the same class."

Since the creditors were all of the same class, it is clear that the payment in full of the claim of the banks amounted to a preference, unless it can be said that the claim of indorser on the note of the bankrupt to the banks is subordinated to the payment of that note in the distribution of the bankrupt's assets. The question, then, is: In the distribution of the assets of a bankrupt, is the independent claim of an indorser subordinated to the claim arising out of the debt of the bankrupt which he has indorsed? The answer to that question must depend upon whether there is anything in the contract of indorsement creating a lien or priority upon the assets of the bankrupt or making it inequitable for the indorser to share equally with other creditors with respect to his independent claim. There is manifestly nothing in the contract of indorsement creating any sort of lien or priority upon the assets of the bankrupt. It seems equally clear that there is nothing in that contract making it inequitable for the indorser to share equally with other creditors in the division of the bankrupt's estate with respect to a claim which does not arise out of the indorsement or have any relation thereto. The contract of indorsement is an agreement to pay that particular debt if the principal debtor fails to pay. It does not create any relationship with respect to any other indebtedness. So far as any independent claim of the indorser is concerned, he is in no different position, because of the indorsement, from any other creditor of the bankrupt.

The learned judge below was of opinion that, because Leo and Myers had indorsed the notes of the banks, they were precluded from claiming anything on their claims until the banks were paid in full. This rule applies where the claim asserted arises out of payment of indorsed notes or performance of a guaranty or indemnity agreement. It is based upon the equitable doctrine that one who has guaranteed the payment of an obligation and who is subrogated to rights under it upon payment, may not assert it as a claim to the detriment of those it was intended to protect. See *American Surety Co. v. Sampsell,* 327 U. S. 269; *American Surety Co. v. Electric Co.,* 296 U. S. 133; *Jenkins v. National Surety Co.,* 277 U. S. 258; *Swarts v. Siegel,* 8 Cir. 117 F. 13; Collier on Bankruptcy, 14 ed., vol. 3, p. 1847. The claim of Leo here, however, is not a claim to which this doctrine has any application. It does not arise out of any indorsement or guaranty, but is an entirely independent claim; and there is no reason, so far as the record shows, why it should be postponed in payment to any other indebtedness owing by the corporation. The fact that a creditor of a corporation indorses its paper does not mean that he agrees that the paper which he indorses be given any lien upon the assets of the corporation or any priority over any claim which he may have against it. It means merely that he will pay the indorsed note if the corporation does not do so. There is nothing in this which justifies subordinating any independent claim which he may have against the corporation to the claim which he has indorsed. No case has been cited upholding any such proposition and we know of none.

There is nothing in *Pepper v. Litton,* 308 U. S. 295, which justifies the subordination or postponement of

the independent claims of Leo and Myers to the claim of the bank merely because they were indorsers on paper which the bank held. There is nothing to show that there was any fraud in connection with these claims, that they represented mere capital contributions or that they were anything other than bona fide debts owing by the corporation. For the principles justifying the subordination of claims, see *Pepper v. Litton,* supra; *Sampsell v. Imperial Paper Corp.,* 313 U. S. 215; Collier on Bankruptcy, 14 ed., vol. 3, p. 1810 and cases there cited.

In the peculiar circumstances of this case, the preferential payment to the banks would not result in prejudice to other creditors but for the insolvency of the Leo estate. Since Leo and Myers were the only other creditors and had independent claims in equal amounts, the payment to the banks would have inured equally to the benefit of both and each would have been relieved of making a payment equal to what he would have received from the distribution of the bankrupt's assets. Because of the insolvency of Leo, however, this result does not follow. The amount which his estate would have to pay on the claim arising out of the indorsement would not be the same as the amount he would receive from the assets of the bankrupt but decidedly less; and there is no principle upon which one claim could be offset against the other, since the bankrupt is the debtor with respect to both. If the $14,000 assets of the corporation had been ratably distributed among its creditors, the banks would have received approximately $4,000 and Leo and Myers would have received on their claims approximately $5,000 each. Leo's liability on his indorsement to the banks would have been approximately $5,000; but this liability

would have been a mere claim against his estate. The $5,000 received from the assets of the corporation would be an asset of the estate for the benefit of all its creditors. The effect of the preferential transfer which Myers caused the corporation to make is to take this asset from the creditors of Leo's estate and use it to extinguish in full a liability of the corporation for which Myers and Leo were secondarily liable, and thus benefit Myers at the expense of Leo's creditors. This is just the sort of thing that the Bankruptcy Act was intended to prevent.

For the reasons stated, the order dismissing the petition will be reversed and the case will be remanded for further proceedings not inconsistent herewith.

Reversed.

SOPER, Circuit Judge, dissenting:

This is an appeal from an order of the District Court dismissing a petition in bankruptcy filed on August 16, 1954 against L & M Realty Corporation, a Virginia corporation, based on the ground that on August 12, 1954 the corporation had committed an act of bankruptcy in that while insolvent, it paid in full a note of $9,000 owing by it to the National Bank of Commerce and a note of $5,000 owing by it to the Seaboard Citizens Bank, thereby making a preferential transfer, as defined in 11 U.S.C.A. 96 (a) (1), the effect of which was to enable the banks to obtain a greater percentage of their debts than other creditors of the same class.

The facts are simple and undisputed. The only stockholders of the corporation were Dr. Louis S. Leo

and Dr. Edward Myers. The only creditors of the corporation were the two banks in the sums mentioned, and the two stockholders, each of whom had loaned the corporation approximately $17,000. Each of them had also endorsed the notes held by the banks. The only asset of the bankrupt corporation was the sum of $14,000 in cash, and this was used, as we have seen, to pay the notes held by the banks. At the time that the petition in bankruptcy was filed Leo was dead and his estate was insolvent. The payments to the banks were made at the instance of Myers, so that he would not be obliged as an endorser to pay more than his fair share of the notes held by the bank. The petition in bankruptcy was filed by the executrix of Leo in the hope that the monies paid to the bank might be recovered as preferential payments so that the creditors of the insolvent estate of Leo might participate in the distribution of the assets of the bankrupt corporation. In such case Myers would be obliged to make good the shortage to the banks.

From these circumstances it is manifest that the payments to the banks were not preferential in the statutory sense since they did not deprive any creditor of a share of the bankrupt's estate which he was entitled to receive. It is true that in the rule set forth in *Swartz v. Fourth Natl. Bank,* 8 Cir., 117 F. 1, and subsequent decisions, Leo and Myers belonged to the same class of creditors as the banks, although the notes held by the banks were endorsed by them; but Leo and Myers were not entitled to share the assets of the bankrupt equally with the banks because they had surrendered their right to participate by their contracts of endorsement until the banks had been paid. The banks of course had no lien on the assets and would have had no priority

over other creditors had there been any; but they were entitled to be paid before the creditors who had endorsed the obligations which they held.

The equitable principle has been frequently laid down and applied that a surety may not share a bankrupt's estate on equal terms with creditors whom the surety has undertaken to secure. In *American Surety Co. v. Electric Co.*, 296 U. S. 133, it was held that a surety company, which had executed a statutory construction bond to satisfy the claims of labor and material men against the building contractor, and had paid the full amount of its bond, had no right to compete with creditors of the contractor who had not been paid for labor or material; and the same rule was applied in *American Surety Company v. Sampsell*, 327 U. S. 267, as to the claims of material men who had not filed their claims in due time and had thereby lost their right to recover under the bond. The Supreme Court went further in *Jenkins v. National Surety Co.*, 277 U. S. 258, where it held that the surety company could not compete with the creditor it had agreed to protect, although the surety's claim was not based on the right of subrogation but upon a separate agreement of indemnity between the surety company and the principal in the bond.*

It is contended that this principle should not be applied in the instant case because the claims of Leo and Myers are independent of the claims of the banks, whereas, in the cited cases, the rule was applied to claims of the surety which were connected with or grew

* See also Foutz v. Maryland Cas. Co., 4 Cir., 30 F. 2d 357; See also Central States Corp. v. Luther, 10 Cir., 215 F. 2d 38, 46; In re Prudence-Bonds Corp., 2 Cir., 102 F. 2d 531, 534; Amick v. Columbia Casualty Co., 8 Cir., 101 F. 2d 984, 986.

out of the obligations which it had assumed. There is, however, no intimation in the decided cases that the equitable principle should be strictly limited to the circumstances therein disclosed; and there is no good reason why it should be so limited. Moreover, it is not necessary for our present purposes to hold that the principle should be extended to all cases in which one creditor has endorsed or guaranteed the indebtedness due another. It is sufficient to point out that under the unusual circumstances of the pending case, it would be inequitable to permit the endorsers to press their claims in competition with the claims of the banks.

The injustice of such a proceeding is easily shown. Except for the limited liability of the stockholders for the debts of the L & M Realty Company, the business in effect belonged to and was conducted by Leo and Myers as if they were partners each of whom had a one-half interest in the enterprise. When the business was in need of money they advanced additional sums in the form of loans to carry it on and when more money was needed they persuaded the banks to make loans to the corporation upon their endorsements. It would obviously be most inequitable to permit the owners of the business to apply its assets to the payment of their own claims until they had made good on their guarantees to the banks. If, in the cited cases, it was inequitable for a surety company, which had completely complied with its contract of indemnity by paying to the creditors the full amount of its bond, to compete with the creditors of the bankrupt contractor, how can the endorsers in the instant case, who have paid no part of the obligations which they guaranteed, be allowed to participate?

It is conceded in the opposing argument that if Leo's estate were solvent, the payments to the banks

would not have prejudiced the other two creditors because each of them would have been relieved of his obligation as endorser. This is true, but it is also conclusive of the whole controversy. It is manifest that Leo, insolvent, had no greater claim against the corporation than Leo, solvent, would have had. Undoubtedly the effect of the payments to the banks was to deprive Leo's creditors of a share of the assets of the bankrupt corporation, but Leo's creditors had no greater right to object than Leo himself. The argument confuses the creditors of Leo with the creditors of the bankrupt corporation. The section of the bankruptcy act which defines the preferential transfer of the property of an insolvent is designed to protect *his* creditors; but is not concerned with the creditors of his creditors.

APPENDIX OF PETITIONER

In The

UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA

Norfolk Division

In the matter of

L & M REALTY CORPORATION,

Alleged Bankrupt

In Bankruptcy—No. 16,727

ORDER DISMISSING PETITION

This matter came on to be heard on the Petition for Review filed by Rena C. Leo, Executrix of the Estate of Louis S. Leo, Deceased, to the judgment of the Referee in Bankruptcy, to whom this cause has heretofore been referred, dismissing the Involuntary Bankruptcy herein filed, and upon the arguments of Counsel for the petitioner and Counsel for the alleged bankrupt, and it appearing to the Court that the judgment of the Referee in dismissing the Petition in Involuntary Bankruptcy is plainly right, it is therefore

ADJUDGED, ORDERED and DECREED, that the judgment of said Referee in dismissing said Petition is hereby sustained and said Petition is hereby dismissed, with prejudice, to which action of the Court the Petitioner, by her Counsel, duly excepted.

United States District Judge
/s/ WALTER E. HOFFMAN

Norfolk, Virginia
May 19, 1955

(Caption Omitted)

OPINION

On a review of the Referee's findings and conclusions in the above matter, the facts are not in dispute. The alleged bankrupt corporation was a "close" corporation of two stockholders who were its officers and directors, Dr. Louis S. Leo and Dr. Edward Myers. During the five year period prior to the filing of the involuntary petition herein, Leo and Myers advanced to the corporation the approximate sums of $17,000.00 and $18,000.00 respectively. It is admitted that these advances are genuine and not tainted with fraud as is so frequently the case in bankruptcy proceedings involving such corporations. Shortly prior to the filing of the involuntary petition the corporation was similarly indebted to two local banks, one in the sum of $5,000.00 the other in the amount of $9,000.00. Both bank notes carried the endorsements of Leo and Myers. Leo died prior to the filing of the petition and his estate is insolvent. After Leo's death and prior to the bankruptcy proceedings, Myers caused or permitted the banks to be paid in full from corporate funds, all of which was done within four months prior to the filing of the petition in involuntary bankruptcy. There are *no other creditors* involved.

The act of bankruptcy alleged is the contended "preference" in paying the banks within the period in question while the corporation was insolvent. While there are other defenses asserted in the answer, it is unnecessary to discuss the merits of same as the Referee's order dismissing the petition must be sustained.

Had a voluntary petition been filed prior to the payments to the banks, the creditors would have been as follows:

Bank No. 1—$5,000.00 (Note endorsed by Leo and Myers)

Bank No. 2—$9,000.00 (Note endorsed by Leo and Myers)

Estate of Louis S. Leo—$17,000.00 (more or less)

Dr. Edward Myers—$18,000.00 (more or less)

Since Leo's estate is insolvent, the rather obvious purpose of the bankruptcy is to permit the estate to share on a pro-rata basis, thereby leaving Myers the obligation to pay any existing deficit on any amount remaining due and owing the banks. It is a matter of common knowledge that banks do not care to seek payment from the estate of a deceased person when there is a living co-endorser who is perfectly solvent. All of the equities of the case are, therefore, with Myers, and he cannot be criticized for using corporate funds in paying obligations on which he and Leo were, in effect, jointly interested.

While the Referee did not have the benefit of the authorities submitted to this Court on review, and based his conclusion on the equitable principles as set forth in *Pepper v. Litton,* 308 U. S. 295, he arrived at the correct conclusion.

The petitioner is relying upon Title 11, U.S.C.A. § 96(a) (1), which states:

> "A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an

antecedent debt, made, or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the *same class*".

The essence of petitioner's argument is that the two banks herein are in the same class as the two creditors, Drs. Leo and Myers, and that the payment of the $14,000.00 to the two banks constituted a preference since it is alleged that the banks will receive a greater percentage than the two other creditors.

In answering this argument it is first necessary to determine whether or not a creditor who enjoys the assurance of a guarantor or surety of the debt is in a different class from a creditor who has no guarantor of the liability. There is authority that the two creditors are in different classes. *In re Harpke, et al* (7th CCA), 116 F. 295.

The *Harpke* case is discussed and repudiated after careful reasoning by the Eighth Circuit in *Swarts v. Fourth Nat. Bank of St. Louis,* 117 F. 1, 5. The court there reasons:

> "The test of classification is the percentage paid upon the claims out of the estate of the bankrupt."

This court adopts the position of the Eighth Circuit in the absence of any case in point in the Fourth Circuit. If, in the case at bar, there had been no payment to the banks (and the endorsers and creditors were not the same persons), each bank and each creditor would have shared proportionately in the proceeds of

the bankrupt's estate. Under such circumstances these four creditors would belong to the same class.

At this point, if the court were to apply the exact wording of Title 11, USCA § 96(a)(1), the petitioner's position would be correct. However, it is necessary to consider the effect of the statement in parentheses above wherein it is said "and the endorsers and creditors were not the same persons." If someone other than Leo and Myers were the endorsers on the banks' loans, Title 11, USCA § 96(a)(1) would be applicable and the payment to the banks by Myers would be a preference which the Bankruptcy Court could set aside. When, however, the sole stockholders in the corporation endorsed the notes to the banks, these stockholders contracted to see that the banks would be paid. Certainly these same stockholders cannot be permitted to come into this court and claim the right to be paid before the banks have recovered the entire amount owed to them. It is the duty of this court to see that equity prevails.

As said by Mr. Justice Douglas in *Pepper v. Litton*, 308 U. S. 295, 307:

> "As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy in the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty to do so is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder."

The equitable principle to be applied in this case may well be termed an estoppel. In contracting to guarantee payment to the banks of the amounts owed by the bankrupt corporation, the two stockholders are estopped from asserting any claim which would be in derogation of the rights of the banks in the assets of the alleged bankrupt.

This position is well stated in the opinion of Judge Sanborn in *Swarts v. Fourth Natl. Bank of St. Louis,* supra, at page 12:

> "The contract of Siegel & Bro. was that they would pay these notes if the bankrupt did not. By that contract they are estopped from collecting or receiving anything upon or on account of them from the bankrupt estate, which still owes the full amount of them, until the bank has received the $14,600 which is still due to it on the notes."

In the opinion of the court the cases of *Livingstone v. Heineman,* 120 F. 786, and *In re Star Spring Bed Company,* 257 F. 176, cited by petitioner are not applicable. The *Livingstone* case dealt solely with the question of whether or not the creditors were all of the same class. The case at bar has the added feature of part of the creditors also being guarantors of the debts due the other creditors. The *Star Spring Bed* case involved a preference arising out of the transfer of certain accounts in return for a note, where the value of the accounts exceeded the value of the note. In that case, also, all the creditors were of the same class and the guaranty of some of the creditors by the remaining creditors was not an element as it is in the case at bar.

To further strengthen the position taken by the Referee in this matter, there is no evidence before the

court in regard to the total paid-in capital of the bankrupt corporation. Frequently, in the case of a closely-held corporation, the stockholders, in lieu of subscribing to stock, attempt to put money into the operation of the corporation through the creation of a loan. In many cases this is permissible. In a bankruptcy case it is the duty of the court to look into all aspects of the "loan" in order to insure equitable distribution of the bankrupt's remaining assets.

As said by the Supreme Court in *Pepper v. Litton*, supra, at page 309:

> "And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in the foregoing types of situations but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan."

This court believes that the "loans" of Leo and Myers may actually have been capital contributions rather than loans, in which case there would be no question as to the correctness of the Referee's decision. In view of the foregoing opinion, however, it is not necessary to decide whether or not Leo and Myers actually made loans or capital contributions to the bankrupt corporation.

An order will be prepared by counsel for the alleged bankrupt sustaining the Referee's dismissal of the petition herein in conformity with this opinion.

(SGD) WALTER E. HOFFMAN
United States District Judge

Norfolk, Virginia
May 5, 1955

(Caption Omitted)

CERTIFICATE OF REVIEW

To: The Honorable Walter E. Hoffman, Judge of said Court:

The undersigned Referee in Bankruptcy respectfully submits his certificate of review upon a petition filed on November 24, 1954, to review an order entered by the Referee on November 16, 1954.

STATEMENT OF THE CASE

This proceeding was initiated in this Court by the petition of Rena C. Leo, Executrix of the Estate of Louis S. Leo, deceased, seeking the involuntary adjudication in bankruptcy of L & M Realty Corporation. The corporation filed an answer setting up various defenses. The matter was heard before the Referee after due reference, and the order under review was subsequently entered, dismissing the petition, with leave to the petitioner to amend within twenty days.

QUESTION PRESENTED

The sole question presented on this review is whether the alleged bankrupt, on August 12, 1954, within four months of the filing of the petition, and while insolvent, committed an act of bankruptcy by making preferential payments to the Seaboard Citizens National Bank and National Bank of Commerce, both of Norfolk, two of its creditors.

There is another question possible in this review, in that the Referee declined to pass on other defenses raised by the alleged bankrupt, but if the dismissal of the petitioner be affirmed, it will not be necessary to reach the other questions.

EVIDENCE PRESENTED

There was no conflict in the evidence, and all matters of fact pertaining to the question in issue were stipulated, as shown in the transcript of the proceedings filed with this certificate.

It was *stipulated* that on August 12, 1954, *within four months* of the filing of the involuntary petition of bankruptcy and *while insolvent,* the L & M Realty Corporation paid to National Bank of Commerce the sum of $9,000.00 and to Seaboard Citizens National Bank the sum of $5,000.00, which payments satisfied in full the existing obligation of the alleged bankrupt corporation to the two banks. It was also stipulated that the respective obligations of the alleged bankrupt to the two banks were guaranteed by the personal endorsement of the petitioner's decedent and the other principal owner of the alleged bankrupt, Dr. Edward Myers.

It was also stipulated for the purpose of passing on the question of whether a preference had been made, that *petitioner's decedent was a creditor* of the corporation in the amount of $17,501.85, but this stipulation did not extend to other possible defenses of the alleged bankrupt. It was also stipulated that the corporation had no *other creditors except the two banks and the two principals,* Dr. Leo and Dr. Myers, and this stipulation was also limited in its operation to the particular question of whether or not a preference had been effected.

FINDINGS OF FACT

Since the evidence was all stipulated, the statement of the evidence is adopted as the finding of fact of the Referee.

CONCLUSIONS OF LAW

It is concluded by the Referee that the payments of August 12, 1954, do not constitute preferences, because no creditor has thereby obtained a greater percentage of his debt than any other creditors of the same class. The personal endorsement of the obligations of the corporation to the banks by the two other creditors, in effect, created two classes of creditors: (1) the banks, which gained a preferential status; and (2) the guaranteeing creditors, who thereby subordinated their claims.

If, on August 12, 1954, all the assets of the alleged bankrupt had been ratably distributed to all four creditors, still the two banks would have been entitled to make the other two creditors pay over in full the dividend received from the corporation, since it held their personal endorsement of the obligations and was

equitably entitled to payment in full from the corporation, before either of the other two creditors were entitled to be paid any percentage at all.

A preference, as an act of bankruptcy, is defined by the Bankruptcy Act by reference in Section 60a. of the Act Section 60a. reads in part as follows:

". . . the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the *same class. . .*" The Act does not define what is a "class" of creditors, nor has any case been found in point with the one under review. However, it is obvious that creditors of the same class are those entitled to be paid in the distribution of the estate in the same order of priority.

Here the banks are undoubtedly entitled, under the peculiar facts of this case, to be paid in a higher order of priority than the endorsing creditors, since the endorsers are the sole stockholders of the alleged bankrupt, and the rights of no other creditors are involved. It is well established that courts of bankruptcy are essentially courts of equity. As is said in *Pepper v. Litton,* 308 U. S. 295, S. Ct. 238, 84 L. Ed. 281, in Headnote No. 2:

> "Courts of bankruptcy, in passing upon the validity and priority of claims, exercise equity powers and have not only the power but the duty to disallow or subordinate claims if equity and fairness so require. That power and duty are especially clear where the claim seeking allowance accrues to the benefit of an officer, director or stockholder of the bankrupt."

It is clear under the doctrine of *Pepper v. Litton* that the claims of the stockholders must be subordinated

by this court to the claims of the banks, when the stockholders have personally guaranteed payment of the claims to the banks.

Put another way, petitioner's decedent is estopped to claim that the banks should not be paid in full ahead of himself. By his endorsement, he said, in effect, to the banks: "If the corporation cannot pay you, I will pay you." In a court of equity powers, he cannot be heard to take a different position by way of complaint that the banks have been preferred over him in receiving payment of the very obligation he endorsed.

The petition in involuntary bankruptcy cannot, therefore, be maintained by Dr. Leo's executrix, and the Fourth Defense of the alleged bankrupt should be sustained.

Submitted herewith are the involuntary petition in bankruptcy, answer of the alleged bankrupt, reporter's transcript, and petition for review.

Respectfully submitted,

William C. Worthington,
Referee in Bankruptcy

Norfolk, Virginia
December 30, 1954

(Caption Omitted)

ORDER

This matter came on to be heard on the 4th day of November, 1954, by the undersigned Referee in Bankruptcy upon the Petition in involuntary bankruptcy of

Rena C. Leo, Executrix of the Estate of Dr. Louis S. Leo, deceased, upon the answer of the alleged bankrupt herein filed, upon the stipulations of counsel for both the Petitioner and the Alleged Bankrupt with reference to the Fourth Defense contained in said Answer.

And it appearing to the Court that the Fourth Defense should be sustained,

IT IS, THEREFORE, ORDERED That the Petition herein filed be, and the same hereby is, dismissed,

But the Petitioner is hereby granted twenty (20) days from November 4, 1954, in which to file an amended petition herein, to which action of the Court the Petitioner duly excepted,

And the Alleged Bankruptcy duly excepted to the action of the Court in refusing to hear evidence on the Alleged Bankrupt's Third Defense, Fifth Defense, Sixth Defense, Seventh Defense, Eighth Defense, Ninth Defense and Tenth Defense.

/s/ WILLIAM C. WORTHINGTON
Referee in Bankruptcy

Dated at Norfolk, Virginia
November 16, 1954

/s/ WILLIAM C. WORTHINGTON
A copy teste:

.....
Referee in Bankruptcy

Office - Supreme Court, U.S.
FILED
JAN 9 1956
HAROLD B. WILLEY, Clerk

No. 617

APPENDIX OF APPELLANT

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
Norfolk Division

In the matter of
L & M Realty Corporation,
Alleged Bankrupt

In Bankruptcy

No. 16,727

ORDER DISMISSING PETITION

This matter came on to be heard on the Petition for Review filed by Rena C. Leo, Executrix of the Estate of Louis S. Leo, Deceased, to the judgment of the Referee in Bankruptcy, to whom this cause has heretofore been referred, dismissing the Involuntary Bankruptcy herein filed, and upon the arguments of Counsel for the petitioner and Counsel for the alleged bankrupt, and it appearing to the Court that the judgment of the Referee in dismissing the Petition in Involuntary Bankruptcy is plainly right, it is therefore

ADJUDGED, ORDERED and DECREED, that the judgment of said Referee in dismissing said Petition is hereby sustained and said Petition is hereby dismissed, with prejudice, to which action of the Court the Petitioner, by her Counsel, duly excepted.

United States District Judge
/s/ WALTER E. HOFFMAN

Norfolk, Virginia
May 19, 1955

[Caption Omitted]

OPINION

On a review of the Referee's findings and conclusions in the above matter, the facts are not in dispute. The alleged bankrupt corporation was a "close" corporation of two stockholders who were its officers and directors, Dr. Louis S. Leo and Dr. Edward Myers. During the five year period prior to the filing of the involuntary petition herein, Leo and Myers advanced to the corporation the approximate sums of $17,000.00 and $18,000.00 respectively. It is admitted that these advances are genuine and not tainted with fraud as is so frequently the case in bankruptcy proceedings involving such corporations. Shortly prior to the filing of the involuntary petition the corporation was similarly indebted to two local banks, one in the sum of $5,000.00 the other in the amount of $9,000.00. Both bank notes carried the endorsements of Leo and Myers. Leo died prior to the filing of the petition and his estate is insolvent. After Leo's death and prior to the bankruptcy proceedings, Myers caused or permitted the banks to be paid in full from corporate funds, all of which was done within four months prior to the filing of the petition in involuntary bankruptcy. There are *no other creditors* involved.

The act of bankruptcy alleged is the contended "preference" in paying the banks within the period in question while the corporation was insolvent. While there are other defenses asserted in the answer, it is unnecessary to discuss the merits of same as the Referee's order dismissing the petition must be sustained.

Had a voluntary petition been filed prior to the payments to the banks, the creditors would have been as follows:

Bank No. 1—$5,000.00 (Note endorsed by Leo and Myers)
Bank No. 2—$9,000.00 (Note endorsed by Leo and Myers)
Estate of Louis S. Leo—$17,000.00 (more or less)
Dr. Edward Myers—$18,000.00 (more or less)

Since Leo's estate is insolvent, the rather obvious purpose of the bankruptcy is to permit the estate to share on a pro-rata basis, thereby leaving Myers the obligation to pay any existing deficit on any amount remaining due and owing the banks. It is a matter of common knowledge that banks do not care to seek payment from the estate of a deceased person when there is a living co-endorser who is perfectly solvent. All of the equities of the case are, therefore, with Myers, and he cannot be criticized for using corporate funds in paying obligations on which he and Leo were, in effect, jointly interested.

While the Referee did not have the benefit of the authorities submitted to this Court on review, and based his conclusion on the equitable principles as set forth in *Pepper* v. *Litton*, 308 U. S. 295, he arrived at the correct conclusion.

The petitioner is relying upon Title 11, U.S.C.A. §96(a)(1), which states:

> "A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made, or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the *same class*".

The essence of petitioner's argument is that the two banks herein are in the same class as the two creditors, Drs. Leo and Myers, and that the payment of the $14,000.00 to the two banks constituted a preference since it is alleged that the banks will receive a greater percentage than the two other creditors.

In answering this argument it is first necessary to determine whether or not a creditor who enjoys the assurance of a guarantor or surety of the debt is in a different class from a creditor who has no guarantor of the liability. There is authority that the two creditors are in different classes. *In re Harpke, et al* (7th CCA), 116 F. 295.

The *Harpke* case is discussed and repudiated after careful reasoning by the Eighth Circuit in *Swarts* v. *Fourth Nat. Bank of St. Louis,* 117 F. 1, 5. The court there reasons:

> "The test of classification is the percentage paid upon the claims out of the estate of the bankrupt".

This court adopts the position of the Eighth Circuit in the absence of any case in point in the Fourth Circuit. If, in the case at bar, there had been no payment to the banks (and the endorsers and creditors were not the same persons), each bank and each creditor would have shared proportionately in the proceeds of the bankrupt's estate. Under such circumstances these four creditors would belong to the same class.

At this point, if the court were to apply the exact wording of Title 11, USCA §96(a)(1), the petitioner's position would be correct. However, it is necessary to consider the effect of the statement in parentheses above wherein it is said "and the endorsers and creditors were not the same persons". If someone other than Leo and Myers were the endorsers on the banks' loans, Title 11, USCA §96(a)(1) would be applicable and the

payment to the banks by Myers would be a preference which the Bankruptcy Court could set aside. When, however, the sole stockholders in the corporation endorsed the notes to the banks, these stockholders contracted to see that the banks would be paid. Certainly these same stockholders cannot be permitted to come into this court and claim the right to be paid before the banks have recovered the entire amount owed to them. It is the duty of this court to see that equity prevails.

As said by Mr. Justice Douglas in *Pepper* v. *Litton,* 308 U.S. 295, 307:

> "As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy. In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty to do so is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder".

The equitable principle to be applied in this case may well be termed an estoppel. In contracting to guarantee payment to the banks of the amounts owed by the bankrupt corporation, the two stockholders are estopped from asserting any claim which would be in derogation of the rights of the banks in the assets of the alleged bankrupt.

This position is well stated in the opinion of Judge Sanborn in *Swarts* v. *Fourth Natl. Bank of St. Louis,* supra, at page 12:

> "The contract of Siegel & Bro. was that they would

> pay these notes if the bankrupt did not. By that contract they are estopped from collecting or receiving anything upon or on account of them from the bankrupt estate, which still owes the full amount of them, until the bank has received the $14,600 which is still due to it on the notes".

In the opinion of the court the cases of *Livingstone* v. *Heineman,* 120 F. 786, and *In re Star Spring Bed Company,* 257 F. 176, cited by petitioner are not applicable. The *Livingstone* case dealt solely with the question of whether or not the creditors were all of the same class. The case at bar has the added feature of part of the creditors also being guarantors of the debts due the other creditors. The *Star Spring Bed* case involved a preference arising out of the transfer of certain accounts in return for a note, where the value of the accounts exceeded the value of the note. In that case, also, all the creditors were of the same class and the guaranty of some of the creditors by the remaining creditors was not an element as it is in the case at bar.

To further strengthen the position taken by the Referee in this matter, there is no evidence before the court in regard to the total paid-in capital of the bankrupt corporation. Frequently, in the case of a closely-held corporation, the stockholders, in lieu of subscribing to stock, attempt to put money into the operation of the corporation through the creation of a loan. In many cases this is permissible. In a bankruptcy case it is the duty of the court to look into all aspects of the "loan" in order to insure equitable distribution of the bankrupt's remaining assets.

As said by the Supreme Court in *Pepper* v. *Litton,* supra, at page 309:

> "And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in the foregoing types of situations but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan".

This court believes that the "loans" of Leo and Myers may actually have been capital contributions rather than loans, in which case there would be no question as to the correctness of the Referee's decision. In view of the foregoing opinion, however, it is not necessary to decide whether or not Leo and Myers actually made loans or capital contributions to the bankrupt corporation.

An order will be prepared by counsel for the alleged bankrupt sustaining the Referee's dismissal of the petition herein in conformity with this opinion.

(SGD) WALTER E. HOFFMAN
United States District Judge

Norfolk, Virginia
May 5, 1955

[Caption Omitted]

CERTIFICATE OF REVIEW

To: The Honorable Walter E. Hoffman, Judge of said Court:

The undersigned Referee in Bankruptcy respectfully submits his certificate of review upon a petition filed on November 24, 1954, to review an order entered by the Referee on November 16, 1954.

STATEMENT OF THE CASE

This proceeding was initiated in this Court by the petition of Rena C. Leo, Executrix of the Estate of Louis S. Leo, deceased, seeking the involuntary adjudication in bankruptcy of L & M Realty Corporation. The corporation filed an answer setting up various defenses. The matter was heard before the Referee after due reference, and the order under review was subsequently entered, dismissing the petition, with leave to the petitioner to amend within twenty days.

QUESTION PRESENTED

The sole question presented on this review is whether the alleged bankrupt, on August 12, 1954, within four months of the filing of the petition, and while insolvent, committed an act of bankruptcy by making preferential payments to the Seaboard Citizens National Bank and National Bank of Commerce, both of Norfolk, two of its creditors.

There is another question possible in this review, in that the Referee declined to pass on other defenses raised by the alleged bankrupt, but if the dismissal of the petitioner be affirmed, it will not be necessary to reach the other questions.

EVIDENCE PRESENTED

There was no conflict in the evidence, and all matters of fact

pertaining to the question in issue were stipulated, as shown in the transcript of the proceedings filed with this certificate.

It was *stipulated* that on August 12, 1954, *within four months* of the filing of the involuntary petition of bankruptcy and *while insolvent,* the L & M Realty Corporation paid to National Bank of Commerce the sum of $9,000.00 and to Seaboard Citizens National Bank the sum of $5,000.00, which payments satisfied in full the existing obligation of the alleged bankrupt corporation to the two banks. It was also stipulated that the respective obligations of the alleged bankrupt to the two banks were guaranteed by the personal endorsement of the petitioner's decedent and the other principal owner of the alleged bankrupt, Dr. Edward Myers.

It was also stipulated for the purpose of passing on the question of whether a preference had been made, that *petitioner's decedent was a* creditor of the corporation in the amount of $17,501.85, but this stipulation did not extend to other possible defenses of the alleged bankrupt. It was also stipulated that the corporation had no *other creditors except the two banks and the two principals,* Dr. Leo and Dr. Myers, and this stipulation was also limited in its operation to the particular question of whether or not a preference had been effected.

FINDINGS OF FACT

Since the evidence was all stipulated, the statement of the evidence is adopted as the finding of fact of the Referee.

CONCLUSIONS OF LAW

It is concluded by the Referee that the payments of August

12, 1954, do not constitute preferences, because no creditor has thereby obtained a greater percentage of his debt than any other creditors of the same class. The personal endorsement of the obligations of the corporation to the banks by the two other creditors, in effect, created two classes of creditors: (1) the banks, which gained a preferential status; and (2) the guaranteeing creditors, who thereby subordinated their claims.

If, on August 12, 1954, all the assets of the alleged bankrupt had been ratably distributed to all four creditors, still the two banks would have been entitled to make the other two creditors pay over in full the dividend received from the corporation, since it held their personal endorsement of the obligations and was equitably entitled to payment in full from the corporation, before either of the other two creditors were entitled to be paid any percentage at all.

A preference, as an act of bankruptcy, is defined by the Bankruptcy Act by reference in Section 60a. of the Act Section 60a. reads in part as follows:

". . . the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the *same class* . . ." The Act does not define what is a "class" of creditors, nor has any case been found in point with the one under review. However, it is obvious that creditors of the same class are those entitled to be paid in the distribution of the estate in the same order of priority.

Here the banks are undoubtedly entitled, under the peculiar facts of this case, to be paid in a higher order of priority than the endorsing creditors, since the endorsers are the sole stockholders of the alleged bankrupt, and the rights of no other creditors are involved. It is well established that courts of bankruptcy are essentially courts of equity. As is said in *Pepper* v.

Litton, 308 U.S. 295, S.Ct. 238, 84 L.Ed. 281, in Headnote No. 2:

> "Courts of bankruptcy, in passing upon the validity and priority of claims, exercise equity powers and have not only the power but the duty to disallow or subordinate claims if equity and fairness so require. That power and duty are especially clear where the claim seeking allowance accrues to the benefit of an officer, director or stockholder of the bankrupt."

It is clear under the doctrine of *Pepper* v. *Litton* that the claims of the stockholders must be subordinated by this court to the claims of the banks, when the stockholders have personally guaranteed payment of the claims to the banks.

Put another way, petitioner's decedent is estopped to claim that the banks should not be paid in full ahead of himself. By his endorsement, he said, in effect, to the banks: "If the corporation cannot pay you, I will pay you." In a court of equity powers, he cannot be heard to take a different position by way of complaint that the banks have been preferred over him in receiving payment of the very obligation he endorsed.

The petition in involuntary bankruptcy cannot, therefore, be maintained by Dr. Leo's executrix, and the Fourth Defense of the alleged bankrupt should be sustained.

Submitted herewith are the involuntary petition in bankruptcy, answer of the alleged bankrupt, reporter's transcript, and petition for review.

Respectfully submitted,

William C. Worthington
Referee in Bankruptcy.

Norfolk, Virginia
December 30, 1954.

[Caption Omitted]

ORDER

This matter came on to be heard on the 4th day of November, 1954, by the undersigned Referee in Bankruptcy upon the Petition in involuntary bankruptcy of Rena C. Leo, Executrix of the Estate of Dr. Louis S. Leo, deceased, upon the Answer of the Alleged Bankrupt herein filed, and upon the stipulations of counsel for both the Petitioner and the Alleged Bankrupt with reference to the Fourth Defense contained in said Answer.

And it appearing to the Court that the Fourth Defense should be sustained,

IT IS, THEREFORE, ORDERED That the Petition herein filed be, and the same hereby is, dismissed,

But the Petitioner is hereby granted twenty (20) days from November 4, 1954, in which to file an amended petition herein, to which action of the Court the Petitioner duly excepted,

And the Alleged Bankruptcy duly excepted to the action

of the Court in refusing to hear evidence on the Alleged Bankrupt's Third Defense, Fifth Defense, Sixth Defense, Seventh Defense, Eighth Defense, Ninth Defense and Tenth Defense.

/s/ WILLIAM C. WORTHINGTON
Referee in Bankruptcy

Dated at Norfolk, Virginia
November 16, 1954.

/s/ William C. Worthington
A copy teste:

_____
Referee in Bankruptcy.

Office - Supreme Court
FEB 3 195
HAROLD B. WILLEY,

IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

RECORD NO. 617

L & M REALTY CORPORATION, a Virginia Corporation, Alleged Bankrupt,

Petitioner

v.

RENA C. LEO, Executrix of the Estate of Dr. Louis S. Leo, Deceased, Petitioning Creditor,

Respondent

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

SAMUEL GOLDBLATT and
PAUL M. LIPKIN
407 Bank of Commerce Building
Norfolk, Virginia

Counsel for Respondent

THE RELIANCE PRESS OF NORFOLK, VA., INC.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

RECORD NO. 617

L & M REALTY CORPORATION, a Virginia Corporation, Alleged Bankrupt,
Petitioner

v.

RENA C. LEO, Executrix of the Estate of Dr. Louis S. Leo, Deceased, Petitioning Creditor,
Respondent

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

QUESTION PRESENTED

Whether the alleged bankrupt committed an act of bankruptcy by paying in full and while insolvent two bank notes made by it and endorsed by its two sole stockholders, the said stockholders being bona fide creditors for advances made to it and the only other creditors of the alleged bankrupt.

STATEMENT

On August 12th, 1954, within four months of the filing of the involuntary petition of bankruptcy and while insolvent, the L & M Realty Corporation paid to the National Bank of Commerce the sum of $9,000.00 and to the Seaboard Citizens Bank the sum of $5,000.00, which payments satisfied in full the existing obligations of the Corporation to these two banks. The notes evidencing these obligations of the L & M Realty Corporation to the banks were endorsed personally by Dr. Louis S. Leo, respondent's decedent and Dr. Edward Myers, the two principal owners of the Corporation, they being also officers and directors. At the time of said payments to the bank, the estate of Dr. Louis S. Leo was a creditor of the Corporation in the amount of $17,501.85 and Dr. Edward Myers was a creditor of the Corporation in a similar amount or more.

It was also stipulated for the sole question of whether or not a preference had been effected by the payment to the banks, that the Corporation had no other creditors except the two banks and the two principals, the estate of Dr. Leo and Dr. Edward Myers. The indebtedness of the two principals were bona fide debts over and above the capital invested in the Corporation and were genuine advances made to the Corporation. The Leo estate is insolvent.

REASONS FOR NOT ALLOWING THE WRIT

1. Petitioner states in its first alleged reason for allowing the writ that the decision of the Fourth Circuit in the instant case is in direct conflict with *In re Harpke,* 116 Fed. 295 (7th Cir. 1902) which the Sixth

and Eighth Circuits refused to follow in *Livingstone v. Heineman,* 120 Fed. 786 (6th Cir. 1903) and *Swartz v. Fourth National Bank,* 117 Fed. 1 (8th Cir. 1902).

It is to be assumed from this argument of petitioner that it is its contention that the Harpke case sustains its position and should be followed. Yet this is a misleading proposition. Petitioner does not rely upon the Harpke case. In petitioner's brief before the Fourth Circuit at the bottom of page seven (7) petitioner says: "However, we do not consider this case (*In re Harpke*) in point or remotely helpful to a solution of the issues before us." Again in the second paragraph of page eight (8) of that brief, petitioner added: "In the Harpke case the Court held that the payment of the endorsed note to the bank created no preference because the endorsed note occupied a different "class" from the unendorsed note. We make no such contentions in the case at bar, and we do not agree with the conclusions reached in the Harpke case."

Thus petitioner does not think that this court should rule in his favor on the basis of the Harpke case. Neither the dissenting opinion in the Court below, nor the District Court opinion nor the referee in bankruptcy's ruling follow the Harpke case, although said opinions and ruling were in favor of petitioner.

Respondent therefore respectfully submits that petitioner is thus attempting to raise a false conflict of decisions in its quest for a Writ of Certiorari.

2. In its second alleged reason why the writ should be allowed, petitioner contends that while the Court below apparently followed the decision of *Swartz v. Fourth National Bank,* supra, it refused to

follow the equitable principle of estoppel therein enunciated.

But the opinion of the Court below clearly and decisively explained why this principle was not applicable to the instant case. (See Appendix A of Petition, p. 4). In the Swartz case the court estopped the endorser from obtaining a dividend from the bankrupt upon that portion that it paid to the note holder by virtue of its endorsement until the holder of the note had recovered its claim in full. In the instant case respondent is not claiming to be a creditor merely because of her decedent's endorsement. She is asserting a valid, bona fide, independent claim.

The fourth and fifth alleged reasons why petitioner should be allowed a writ are similar to each other and the same as set out in petitioner's second reason, indicative of petitioner's weak position by attempting to stretch nothing into something.

The fourth reason calls the decision below in conflict with this Court's opinion in *Pepper v. Litton,* 308 U. S. 295 (1939) (See Petition, p. 5). But the opinion of the lower court effectively distinguishes the *Pepper* case which dealt with a fraudulent claim asserted by the stockholder; here the *bona fides* of respondent's debt was stipulated by petitioner. (See Petition, Appendix A, p. 4). Not even the dissenting opinion in the Court below claimed that the majority opinion was in conflict with *Pepper v. Litton.*

The alleged fifth reason of petitioner is identical with its second reason except it cites different cases than that previously cited by it. But again respondent wishes to point out, as did the Court below, that the estoppel

theory of the cases cited estopped a claim on the endorsement until the holder had been made whole. Here the claim is an independent one and no estoppel should arise.

Therefore respondent respectfully submits that not only was the Court below plainly correct but also the equitable principles alluded to are not applicable to the instant case.

3. In answer to petitioner's third alleged reason why the writ should be allowed, respondent respectfully submits that the issue in the present case is uniquely narrow, and no amount of strained semantics can convert it into one warranting review by this Court on Certiorari. It is to be noted that there are no cases in point to be found for either side. This is a clear refutation of petitioner's assertion that "this case is . . . of importance to the administration of the Federal Bankruptcy Laws." (Petition, page 6). It is true as stated by petitioner that this Court has not to date had a single case defining "creditor of the same class" at issue in this case. That probably is because the opinion of Judge Sanborn in *Swartz v. Fourth National Bank,* supra, decided in 1902, followed in *Livingstone v. Heineman,* supra, decided in 1903 and In re *Star Spring Bed Co.,* 257 Fed. 176 (D.N.J. 1919), defined "creditor of the same class" so conclusively that never again was its definition in doubt.

In addition thereto the facts in the instant case are extremely unique; not one case has petitioner cited in point in the many thousands arising under the bankruptcy laws. This fact completely belies petitioner's statement that "settlement of the question presented by

this petition is obviously in the public interest, since it is likely to be presented in almost every bankruptcy proceedng affecting closely held corporations." Petitioner is grasping at straws when it attempts to convert a correct decision in a highly unique factual situation into an important question of Federal law, when in fact it has never arisen since the enactment of the Bankruptcy Act and will likely never arise again.

CONCLUSION

For the foregoing reason, it is respectfully submitted that this petition for a Writ of Certiorari should be denied.

Respectfully submitted,

PAUL M. LIPKIN

Of Counsel for Respondent

SAMUEL GOLDBLATT and
PAUL M. LIPKIN
407 Bank of Commerce Building
Norfolk 10, Virginia
Counsel for Respondent

I, Norris E. Halpern, Counsel for Petitioner, do hereby acknowledge that a copy of the foregoing brief for respondent in opposition to a Writ of Certiorari was duly served upon me by delivery of the same to me by counsel for respondent this 30th day of January, 1956.

NORRIS E. HALPERN,

Counsel for Petitioner